Internal Revenue Service

memorandum

date: 17 JAN 2001

to: Ike Eichelberger, Team Coordinator
Internal Revenue Service, LMSB
Denver, Colorado

from: Alice M. Harbutte, Attorney
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subject: [redacted]

This memorandum is in response to your request for an advisory opinion dated November 16, 2000, concerning two issues. First, the characterization of an investment made by [redacted] in a joint venture it entered into with a [redacted] entity, [redacted] as either debt or equity. Second, the date [redacted] interest in the [redacted] entity became worthless for purposes of deducting the loss resulting from this investment.

ISSUES

1. Whether a [redacted] interest held by the [redacted] a U.S. entity, in a joint venture known as [redacted] was a capital investment by [redacted] or became a debt obligation of [redacted] once [redacted] exercised a Put option under the terms of the joint venture agreement.

2. Whether [redacted]s interest in [redacted] became worthless in [redacted] thus entitling [redacted] to deduct a loss from the worthlessness of this interest and whether such loss should be characterized as a capital loss deduction under I.R.C. § 165 or an ordinary bad debt loss under I.R.C. § 166.

CONCLUSIONS

1. [redacted] made a capital investment in [redacted] thus [redacted]s interest in [redacted] is an equity interest. [redacted]s interest in [redacted] was not converted to a debt for U.S. income tax purposes and [redacted] is not entitled to a bad debt loss under I.R.C. 166.

2. Any loss that [redacted] is entitled to would be pursuant to I.R.C. 165. Based upon the facts known so far it appears that this interest may have become worthless as early as [redacted], after [redacted]s restructuring attempts failed or in [redacted] when the assets of [redacted] were sold. Any loss claimed by [redacted] should be characterized as a capital loss under I.R.C. § 165 and not as an ordinary bad debt loss under I.R.C. § 166.

FACTS

The [redacted] Joint Venture:

In [redacted] the [redacted] s [redacted] conglomerate and the [redacted] set up a joint venture [redacted] company called [redacted]. A [redacted] entity, [redacted] held a [redacted]% interest in the joint venture and [redacted] held a [redacted]% interest in the joint venture (the [redacted]). The joint venture agreement between [redacted] and [redacted] is dated [redacted]. Under paragraph [redacted] of the joint venture agreement the [redacted] was to borrow, by loan, enough money to construct the [redacted] facilities.

The initial capital structure of [redacted] is set forth in the joint venture agreement at Article [redacted] entitled "[redacted]" In reading this section of the joint venture agreement it is clear that [redacted] is making a capital contribution and is obtaining shares in the joint venture. Article [redacted] entitled "[redacted]" states:

[redacted]

[redacted] After the first stage contribution:

[redacted]

[redacted] After the second stage contribution:

[redacted]

It is clear by the express terms of the joint venture agreement that [redacted] contributed capital and that amounts of cash [redacted] contributed to the joint venture were not loans.

The taxpayer relies upon Article [redacted] of the joint venture agreement entitled "Put Option" to support its position that [redacted]'s capital contributions were converted to debt and thus an ordinary loss under I.R.C. 166 for a bad debt is appropriate.

Article [redacted] provides, in relevant part, as follows:

[redacted]

The remaining provisions of Article [redacted] provide that the Put Option had to be with respect to all of [redacted]s shares. There were two time periods within which [redacted] could exercise this option. First, [redacted] had to wait [redacted] years after manufacturing operations commenced before [redacted] could exercise the option and then [redacted] had a [redacted] year window period to exercise the option. Second, if a "Termination Event" occurred, then [redacted] had [redacted] days to exercise this option. In [redacted] [redacted] missed debt payments and [redacted] was experiencing financial difficulties. In [redacted] filed for bankruptcy protection, which is a "Termination Event" under Article [redacted] of the [redacted] joint venture agreement. On [redacted], [redacted] notified [redacted] that [redacted] was exercising the Put option. [redacted] takes the position, for U.S. tax purposes, that the exercise of the Put option by [redacted] converted [redacted]'s equity interest in [redacted] to a debt of [redacted] and that [redacted] became an unsecured creditor of [redacted]

The financial difficulties of [redacted] & [redacted]

In [redacted], [redacted] was experiencing severe financial difficulties. [redacted] unsuccessfully offered to sell a [redacted] per cent stake in [redacted] to another foreign partner in an effort to avoid bankruptcy. [redacted] and [redacted] had agreed to sell the [redacted]% interest for $[redacted] to the new investor, however no interested party was ever found.

On [redacted], the news wire services reported that [redacted] had defaulted on its commercial paper and the [redacted] Stock Commission placed [redacted] under the section of companies either "under court receivership or bankrupt." [redacted]'s [redacted] creditors were to convene to discuss detailed rescue measures, including the extension of emergency loans and rescheduling of commercial papers. The news report further stated that of the [redacted]'s [redacted] subsidiaries, [redacted] including [redacted] were eligible for the emergency rescue package. [redacted] had posted losses for the second consecutive year in [redacted] amid its key businesses like [redacted]. [redacted]s cash-flow problem was reportedly serious, with debts reaching over [redacted] (US $[redacted]) - [redacted] owed to banks and [redacted] to non-banking financial institutions.

On [redacted] the [redacted] reported the following with respect to [redacted] and the business crisis in [redacted]:

[redacted]

[redacted]

The [redacted] was unsuccessful in its attempt to purchase [redacted]. In [redacted] [redacted] was put up for auction sale by its creditors as a result of the [redacted] bankruptcy. The [redacted] put in a bid for [redacted]. However, on [redacted] [redacted] reported that it was dropping out of the auction for its [redacted] joint venture, [redacted], because of a "[redacted]". [redacted] was competing for [redacted], which was the smallest of [redacted]'s [redacted] against [redacted], which is jointly owned by [redacted]'s [redacted] and [redacted]. In [redacted], [redacted], [redacted], stated: "[redacted]. On [redacted] however, [redacted] was the successful purchaser and reported that it had signed a memorandum of understanding with the creditor banks of [redacted] on its takeover of the bankrupt [redacted].

DISCUSSION

Debt vs. Equity:

The taxpayer seeks to take a bad debt deduction for the [redacted] taxable year under I.R.C. § 166. Section 166(a)(1) provides that there shall be allowed as a deduction any debt which becomes worthless within the tax year. Section 166(a)(2) provides that when satisfied that debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of any part charged off within the tax year, as a deduction.

A bad debt loss, however, is only allowed if a bona fide debt exists. Treas. Reg. § 1.166-1(c) provides, in pertinent part:

> (c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166.

In order for an advance of funds to be considered a debt rather than equity, the courts have stressed that a reasonable expectation of repayment must exist which does not depend solely on the success of the borrower's business. American Processing and Sales Co. v. United States, 371 F.2d 842, 856 (1967). With respect to debt-equity issues, generally, if an instrument denominated as 'debt' in fact represents an investment in the corporation, in the sense that the return on, and of, the investment is dependent on corporate success, the instrument will be treated as 'equity' for tax purposes.

In the present case it is clear the [redacted]'s advance of funds to [redacted] was a capital contribution. The joint venture agreement expressly states that [redacted] is obtaining a [redacted] interest in the joint venture as a co-venturer and not as a creditor.

The issue in the present case arises as a result of the "Put Option" clause contained in the joint venture agreement. [redacted] argues that once it exercised the Put option, [redacted] was compelled to purchase all of [redacted]'s shares in [redacted] converting [redacted]'s equity interest to that of an unsecured creditor. [redacted]'s position is without merit. This is a substance over form issue. In analyzing the position being taken by [redacted] under the debt-equity guidelines set forth by the various courts it is clear that [redacted]'s interest in the joint venture does not qualify as a debt interest for purposes of U.S. taxation.

The courts have devised guidelines to facilitate a determination of whether advances to a corporation constitute debt or equity. Estate of Mixon v. United States, 464 F.2d 394, 403 (5th Cir. 1972). At least thirteen factors have been considered in determining whether an advance of funds is debt or equity.

These thirteen factors are:

(1) the names given to the certificates evidencing the indebtedness;

(2) the presence or absence of a fixed maturity date;

(3) the source of payments;

(4) the right to enforce payment of principal and interest;

(5) participation in management flowing as a result;

(6) the status of the contribution in relation to regular corporate creditors;

(7) the intent of the parties;

(8) 'thin' or adequate capitalization;

(9) identity of interest between creditor and stockholder;

(10) source of interest payments;

(11) the ability of the corporation to obtain loans from outside lending institutions;

(12) the extent to which the advance was used to acquire capital assets; and

(13) the failure of the debtor to repay on the due date or to seek a postponement.

(1) The Name Given to the Certificate
(2) Presence or Absence of a Fixed Maturity Date

Both of these factors are considered together below. Generally, the court will look to the type of certificate used by the parties in considering the debt-equity question. Estate of Mixon, 464 F.2d at 403. "The issuance of a bond, debenture, or note is indicative of a bona fide indebtedness." Estate of Mixon v. United States, 464 F.2d 394, 403 (5th Cir. 1972). Although the form of the instrument may be relevant "the decisive factor is not what the payments are called but what, in fact, they are, and that depends upon the real intention of the parties." Byerlite Corporation v. Williams, 286 F.2d 285, 290 (6th Cir. 1960); see Liflans Corporation v. United States, 390 F.2d 965, 969 (1968). While the issuance of a note may evidence a bona fide indebtedness, an unsecured note due on demand with no specific maturity date, and no payments is insufficient to evidence a genuine debt." Stinnett's Pontiac Service, Inc. v. Commissioner, 730 F.2d 634, 638 (1984).

The presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation. The absence of the same on the other hand would indicate that repayment was in some way tied to the fortunes of the business, indicative of an equity advance. Stinnett's Pontiac, 730 F.2d at 638; Estate of Mixon, 464 F.2d at 404.

No notes were issued in this case and no fixed maturity date was set. [redacted] received shares of stock in [redacted]. [redacted] had the right to remove itself from the joint venture upon the occurrence of certain events and to force [redacted] to buy back [redacted]'s shares of stock. However, no payment terms were set forth in the Put option clause and no sinking fund was created. Additionally, no provisions for interest were included in the event the shares did not increase in value. The facts all indicate that the investment by [redacted] was a capital investment and did not convert to a debt obligation for purposes of I.R.C. § 166.

(3) Source of Payments

If repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital but if repayment is not dependent upon earnings, the transaction reflects a loan to the corporation. Mixon at 405. In the present case it is clear the Put option called for the co-venturer [redacted] to purchase [redacted]s shares. The amount due [redacted] under the Put option was expressly dependent upon the success of [redacted]. The source of the payment was [redacted] the [redacted]% owner of [redacted] and was tied to [redacted]'s ability to pay, thus indirectly tied to the success of [redacted].

(4) Right to enforce repayment.

If there is a definite obligation to repay the advance, the transaction would take on some indicia of a loan. Campbell v. Carter Foundation Production Co., 322 F.2d 827 (5th Cir. 1963).

In discussing this factor in Mixon, and in support of the conclusion that there was a legally binding obligation to repay the advance, the Fifth Circuit described the following facts in support of its determination:

> The only real uncertainty in the collection was a matter of "when" rather than "whether". It is uncontradicted that taxpayer expected to be repaid and that the banking authorities contemplated repayment. The record establishes with little doubt that all parties involved did not consider the advance as providing permanent capital financing, which is ordinarily derived from equity advances, but rather temporary working capital to meet what was thought to be, and what proved to be, a temporary emergency. Once the determinable conditions were met, we have little doubt that the Bank was legally obligated under general principles of creditors' rights to return the funds.

Mixon, 264 F.2d at 406.

[redacted] was entitled to exercise a Put option and compel [redacted] to purchase its shares of stock in [redacted] Under the express terms of the agreement [redacted] was obligated to pay [redacted] for the shares.

Also relevant in analyzing this factor are the steps which were taken to assure repayment in the event the business failed. Whether the advances are secured or unsecured, whether a sinking fund was established by which the principal and interest could be paid were held to be relevant factors. The Fifth Circuit, in finding that the advances were equity rather than debt, stated:

> Our conclusion in this regard is confirmed by the character of the notes themselves. These created no realistic creditor safeguards and no genuine expectations of payment. They contained no enforcement provisions, no specific maturity dates, and no sinking fund from which payments of interest and principal might be made. . . . Furthermore, the notes were unsecured. While they did contain a provision for payment on demand, such a provision cannot be realistically considered as manifesting a genuine interest in repayment in view of the financial condition of the corporation and the complete identity of shareholders and noteholders. A demand for payment of the Tyler notes would have completely havocked the corporation with bankruptcy as a possibility.

Tyler v. Tomlinson, 414 F.2d 844, 849 (5th Cir. 1969).

The joint venture agreement created no realistic creditor safeguards for [redacted] and no genuine expectations of payment, no enforcement provisions, no specific maturity dates, and no sinking fund from which payments of interest and principal might be made. In addition, [redacted]s interest was unsecured. As a result, like the Tyler case, [redacted]s interest even taking into account the Put option remains an equity interest.

(5) Participation in Management flowing as a result of the advance.

[redacted] participated in management to the extent it was able to elect two members to the board of directors of [redacted] This is indicative of an equity interest.

(6) Subordination.

Whether the advance has a status equal to or inferior to that of regular corporate creditors is of some import in any determination of whether taxpayer here was dealing as a shareholder or a creditor. United States v. Henderson, 375 F.2d 36 (5th Cir. 1967); Mixon, 464 F.2d at 406.

The fact that an obligation to repay principal is subordinate to claims of other creditors does not, however, necessarily indicate that the purported debt is in reality an equity contribution, especially where the advance is given a superior status to that of other equity contributions. Harlan v. United States, supra.

[redacted] held an unsecured interest. [redacted]s claim was subordinate to all creditors. Under the terms of the Court composition for [redacted], [redacted] was the last to be paid. This is indicative of an equity interest.

(7) The Intent of the Parties

It is "well-recognized in all areas of the law, that a subjective intent on the part of an actor will not alter the relationship or duties created by an otherwise objectively indicated intent." Estate v. Mixon, 464 F.2d at 407. A court must look not simply at self-serving declarations of the parties, but instead must examine those circumstances surrounding the transaction. Tyler, 414 F.2d at 850. "When a corporation contributor seeks no interest, it becomes abundantly clear that the compensation he seeks is that of an equity interest: a share of the profits or an increase in the value of his shareholdings." Slappey rive Industrial Park v. United States, 561 F.2d 572, 582 (1977).

The relevant inquiry is the actual manner, not the form, in which the parties intended to structure their relationship. If the intended structuring accords with the type arrangement that qualifies for taxation as debt, that intent supports a finding of debt. When, however, the parties structure their relationship in a manner placing funds at the prolonged risk of the businesses;

and the decisions whether to make payments on the advances is to be based on the criteria usually associated with dividend decisions then to the extent that intent is relevant, it favors equity classification. Slappey, 561 F.2d at 583.

[redacted]s investment was placed at the risk of the business it was entering into with [redacted]. If the business succeeded, [redacted] would realize the profits of its investment. If the business did not succeed, [redacted] was given the choice of compelling its co-venturer [redacted] to purchase the shares owned by [redacted] The parties clearly structured [redacted]s investment as a capital contribution with an option to have the shares purchased by [redacted] While the option has some characteristics of a debt, as it required [redacted] to buy [redacted]'s stock, [redacted]'s interest in [redacted] was clearly intended to be a capital contribution. The business failed and [redacted] then exercised its put option. The co-venturer was in bankruptcy and could not afford to repurchase the shares of stock. [redacted] had to look to the assets of [redacted] in order to recover any amounts due [redacted]. [redacted] was not a secured creditor but was essentially last in line to be paid. The only party who had a lesser right to recover was [redacted]. The structure in place resembles an equity interest and not a debtor-creditor relationship between [redacted] and [redacted] or [redacted].

(8) Thin or adequate capitalization.

Thin capitalization is very strong evidence of a capital contribution where (1) the debt to equity ratio was initially high, (2) the parties realized the likelihood that it would go higher, and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses need to commence operations. United States v. Henderson, 375 F.2d 36 (5th Cir. 1967). The funds contributed by [redacted] were to be used for the purchase of capital assets and for meeting expenses needed to commence operations. It appears that the debt-equity ratio of [redacted] was high. By the express terms of the joint venture agreement [redacted]s contribution was a capital contribution.

(9) Identity of interest between creditor and stockholder.

If advances are made by stockholders in proportion to their respective stock ownership, an equity capital contribution is indicated. Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967). A sharply disproportionate ratio between a stockholder's percentage interest in stock and debt is, however, strongly indicative that the debt is bona fide. Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969); Charter Wire, Incorporated v. United States, 309 F.2d 878 (7th Cir.), cert. denied, 372 U.S. 965 (1972); Leach Corporation v. Commissioner, 30 T.C. 563, 579 (1958). The advances/investment made by [redacted] was in proportion to its stock interest, exactly [redacted]%.

(10) Source of Interest payments

The failure to insist on interest payments ordinarily indicates that the payors are not seriously expecting any substantial interest income, but are interested in the future earnings of the corporation or the increased market value of their interest. Curry v. United States, 396 F.2d at 634. The lack of provisions for the payment of interest indicates that the monies advanced here were intended as a contribution to equity capital, rather than an arm's-length debt obligation. Mixon at 409. No interest payments to [redacted] were provided for under the Put option. The amount due to [redacted] was tied to the success of the business.

(11) The extent to which the advance was used to acquire capital assets; and

(12) The failure of the corporation to repay on the due date.

If the advance is utilized to provide working capital for the day-to-day operations and not to acquire capital assets, then the advance reflects a loan rather than a capital contribution. The prompt repayment of an advance as soon as the conditions of repayment were met also indicates a loan. If there is no evidence that the debtor party made no meaningful attempt to repay the alleged obligation then a capital contribution is indicated. See Slappey, 561 F.2d at 582-83. The investment made by [redacted] was to be used to purchase capital assets and provided [redacted] with a [redacted]% ownership interest in those assets. The funds were used to start up the new business. The Put option was exercised by [redacted] only after [redacted] filed for bankruptcy protection. Only one demand letter was sent by [redacted] on [redacted], in an attempt to collect any amounts due. No other attempts to collect have been made by [redacted]. This is indicative of an equity interest and not a debtor-creditor relationship.

A bad debt loss is only allowed if a bona fide debt exists. Treas. Reg. § 1.166-1(c). No bona fide debt existed between [redacted] and [redacted] or [redacted] for U.S. income tax purposes and no bad debt loss is allowable under I.R.C. § 166.

Worthless Stock Deduction

Section 165(a) of the Code provides in general that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. The basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in I.R.C. § 1011 for determining the loss from the sale or other disposition of property. I.R.C. § 165(b).

Treas. Reg. § 1.165-1(b) of the regulations provides that to be allowable as a deduction under section 165(a), a loss must be evidenced by a closed and completed transaction, fixed by identifiable events, and except as otherwise provided in sections not relevant herein, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

Section 165(g) provides, in general, that if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

The amount allowed as a loss is subject to the limitations upon capital losses described in Treas. Reg. § 1.165-1(c)(3). Treas. Reg. § 1.165-5(c).

Based upon the facts presented, it appears that [redacted] would be entitled to deduct a loss under I.R.C. 165(c) in the year its investment in [redacted] became worthless.

Worthlessness: Year of Deduction:

Determination of the year in which securities become worthless for purposes of section 165(a) is a question of fact. In making this determination, the Supreme Court has noted that "no definite legal test is provided by the statute for the determination of the year in which the loss is to be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal test." Boehm v. Commissioner, 326 U.S. 287, 293 (1945), citing Lucas v. American Code Co., 280 U.S. 445, 449 (1930).

In order for a taxpayer to sustain its burden of proof regarding the worthlessness of a security, the taxpayer must demonstrate that the property **has neither liquidating value nor any other potential value**. Morton v. Commissioner, 38 B.T.A. 1270, 1278 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940)(emphasis added).

The liquidating value of stock is evidenced by an excess of assets over liabilities. Steadman v. Commissioner, 50 T.C. 369, 376 (1968). Other "potential value" exists if there is a reasonable expectation that the assets would exceed liabilities in the future, Steadman, supra at 376-77, so that there is a reasonable expectation of future profit. When a corporation has neither liquidating value nor any other potential value, the occurrence in a later year of an identifiable event, such as liquidation or receivership, will not determine the worthlessness of the security, "for already 'its value had become finally extinct.'" Steadman, supra at 377, citing Morton, supra.

The Tax Court's decision in Dorminey v. Commissioner, 26 T.C. 940 (1956), acq. 1957-1 C.B. 4, is particularly instructive. In that case, a taxpayer incorporated a grocery store, purchasing a large number of shares of the corporation. When the store failed to prosper, the taxpayer engaged an experienced grocer to assume management of the store. After evaluating the store's financial condition, current inventory, and future prospects, the manager determined that the store could not continue to operate in its present manner. Accordingly, in November 1947, the taxpayer decided to liquidate the corporation. Although liquidation began in December 1947, it was not completed until May 1948, with creditors receiving only eighty percent of the amount due to them. On these facts, the Tax Court determined that the taxpayer's capital stock in the corporation became worthless in 1947 finding that an excess of liabilities over assets does not necessarily render the stock worthless, but at the end of 1947, liquidation was underway and it was clear that all of the creditors, including petitioner, could not be paid in full thus in 1947 the equity investment in Cash & Carry was worthless. See also Drachman v. Commissioner, 23 T.C. 558, 563-564 (1954), acq. 1955-1 C.B. 4.

In the instant case, the substantial financial reverses of [redacted], beginning in [redacted] made it apparent that [redacted] could not remain a viable entity without being restructured. In [redacted], [redacted] attempted to negotiate such a restructure with the creditors of [redacted]. This attempt was unsuccessful. In [redacted] [redacted] was put up for sale. [redacted] unsuccessfully bid for [redacted] in [redacted]. The facts indicate that by the time [redacted]s attempts to restructure [redacted] failed, [redacted] no longer had a reasonable hope of making [redacted] a viable entity. It appears that [redacted] would be entitled to a capital loss under I.R.C. 165 in either [redacted] or [redacted] depending upon when the restructure attempts ended.

If you have any questions concerning this memorandum please contact Attorney Alice M. Harbutte at (303) 844-2214 ext. 256.

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